# Corporate Governance – Current Challenges

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*"Happy companies have robust growth in revenues, strong balance sheets, and healthy profits that reflect genuine business success, not phony book-keeping.*

*And they share other important traits as well. They abide by high ethical standards, which is a key to their solid success. They don't obstruct the flow of information to shareholders, but rather view the shareholder as the ultimate owner and the ultimate boss. They choose directors on the strength of their abilities, character, and capacity for independent judgment.*

*And their internal controls work well, so that the company's executives can take immediate corrective action when something goes wrong."*

*– Christopher Cox, former Chairman, U.S. Securities and Exchange Commission; Washington, DC.*

Corporate governance is about commitment to values and ethical business conduct. It encompasses laws, regulations, processes and customs affecting the way a company is directed, administered, controlled and managed. It reflects on the company's corporate structure, culture, policies and relationships with its stakeholders. At the heart of corporate governance is timely and accurate disclosure of information regarding the company's economic efficiency, financial performance, ownership, and governance.

Corporate governance practices are being increasingly recognized and their importance today is greater than ever before. Investors today are demanding greater transparency into the company's affairs. They no longer depend on regulators for protection as they have the power to reward or penalize the company based on its governance practices.

The company's Board propels the corporate governance practices. The Board oversees how the management serves and protects the long-term interests of all stakeholders. A proactive, well-informed and independent Board is necessary to ensure the highest standards of corporate governance.

**Structure and Composition of Board**

Good governance cannot be imposed by legislations. It must come from within. The Board, at the apex of the company's corporate governance structure, is the key.

Given the recent events in the financial market and ensuing economic turmoil, it is imperative that we take a hard look at the Board's composition and directors' competency. The role of the Nominations Committee is paramount in this regard. The Committee is expected to rigorously review the composition of the Board and determine whether the Board contains an optimal mix of age, work experience and business acumen. Eminent personalities on the Board do not suffice; their sphere of influence and earnestness are considered more important. Some of the recent developments in the structure and composition of the Board are as follows:

- Most of the corporate governance codes and listing rules require a majority of the independent directors on the Board. The trend, however, seems to move towards having the CEO as the sole insider-director.
- Emphasis is being laid on having a declassified Board. The tenor of the directors is being disrupted as directors are re-elected annually.
- Significant numbers of global companies have demarcated the roles of the CEO and the Chairman and have independent directors occupy the latter chair.
- Majority of the global corporations have a lead or presiding director who evaluates the CEO, supervises the Board's evaluation, co-coordinates the activities of independent directors and advises or comments on the quality, quantity and timelines of information from the management.
- The processes of nomination and induction of new directors have become increasingly rigorous in recent times. Companies are examining the potential candidates' qualification, industry experience, business sense and trust.

**Roles and Duties of the Board**

*"Directors and managements must take upon themselves to improve accountability by setting a "tone at the top", honoring the responsibilities that arise from the trust placed in them by investors. All directors and managements should implement their own best practices for corporate governance that promote integrity, transparency and accountability."*

*– Elisse B. Walter, Commissioner, U.S. Securities and Exchange Commission*

Tone at the top shapes the corporate culture. The Board, the CEO and the Senior Management should be committed to high ethical standards, principles of fair dealing, integrity and professionalism. **Governance**

The Board in the *governance role* ensures compliance with the various statutory legislations, fairness and transparency in all transactions, true and fair reporting of financial statements; proper use of corporate funds, understanding and taking into account the interests of shareholders and relevant stakeholders and determining the values to be promoted throughout the organization.

**Control and Monitoring**

The Board in the *control role* is expected to review committees' functions such as, audit, compensation and nomination of executives; make management responsible and accountable for its actions; evaluate and reward the CEO/ management for good performance and penalize them for non-performance. It is also responsible for monitoring the organization's resources and making sure the management succeeds in utilizing the strengths of employees and neutralizing their weaknesses.

**Strategic Direction**

In the *strategic direction role*, the Board determines business strategies and plans support corporate strategy, reviews and evaluate present and future opportunities as well as threats and risks in the external environment. It also evaluates the company's current and future strengths, weaknesses and risks. It determines strategic options that have to be pursued and decides on the means to implement and support them. Given the current economic upheavals and the failure of corporate governance, the Boards are expected to play a significant role in crisis management, and be pro-active in managing crises. The corporate governance guidelines must clearly specify the person who would lead the crisis management team constituted by the Board.

**Functions of the Board**

The functioning of the Board has undergone a sea change. Being a corporate director today is more demanding than in the past. The Board today comes under immense scrutiny from investors, regulators and other observers. Board members are expected to deal with a variety of pressures, dissent with the CEO's opinions / proposals if need be, and act tough on sensitive matters. The following approaches in the Board's conduct of business are gaining ground:

- Independent directors have meetings in executive sessions. These sessions provide opportunities to the independent directors to review the management's performance.
- The practice of 'board strategy retreat' is gaining momentum. Corporate Boards are spending about 2-3 days annually discussing corporate strategies with the senior management of the company.
- Educating and training of directors has become important, particularly in case of a new director being inducted. Financial literacy of directors is being emphasized.
- The Boards have started laying down charters, codes and guidelines that will guide their functions in a more formal and systematic manner.
- Various committees are being established to bring in expertise in the required fields; hard pressed for time, the Board cannot give adequate time and importance to these fields. This would also help in brining an unbiased opinion on specific matters. The Boards have started setting up a rigorous process of evaluating the performance of the Board as a whole, committees and that of the CEO.

**Challenges**

The world is going through a severe financial crisis leading to a global recession, of a magnitude not contemplated by critics of the free market. The International Monetary Fund estimates that the global financial system will suffer losses of around USD 4 trillion. For the first time since the Second World War, the global economy could contract by up to 2%. Millions of people have lost their jobs; thousands of companies have gone bankrupt, leading the Governments around the world to pump in liquidity into the financial system. Critics say that there is still more pain to come and the financial bubble of the past many years would need time to heal. These events have shattered the trust of investors, regulators and other stakeholders.

The following act as guidelines to manage the journey through these troubled times:

- **Corporate Strategy**: Directors need to look at various aspects of corporate strategy including that of liquidity and financial stability of the corporation, the threats and opportunities that exist in the markets, the skill sets and the expertise required overcoming this crisis. Corporations may have to re-assess their vision and mission statements depending on the changing strategies.
- **Risk Management**: The Boards are expected to focus on risks associated with corporate strategies and business environment. The Board is also expected to provide a clear direction to the management on the degree of risks that the company can withstand. While doing so, the Board has to clearly lay down processes, allocate resources and communicate ways of mitigating strategies to the management. Given the importance of risk management, it is best advised that an independent risk committee be constituted and entrusted with the responsibility of overseeing risk management and mitigation. The Boards must also appoint Chief Risk Officers (CRO) and the CRO should directly report to the CEO and the Board.
- **Communication with Shareholders**: The Boards must establish direct channels of communication with the investors. The Boards must clearly state their corporate strategies to investors and the marketplace, and ensure that appropriate communication channels such as internet, emails, blogs, etc. are used for effective investor communication. The Boards must be open to discuss

sensitive topics such as board composition, compensation, social, and environment issues with the shareholders.

- **Executive Compensation**: Executive compensation is one of the most discussed topics in the corporate world today and may gain more importance in the coming years. Executive pay packets are being subject to scrutiny by investors and regulators. Given the current environment, Boards and compensation committees are expected to scrutinize compensation philosophies and policies with greater care. While the Board should not lose sight of its goal of executive compensation as a tool to attract and retain the best talent, it should also pay due attention to performance principle. The Board should be able to find a balance between the interests of senior executives and that of the investors.
- **Succession Planning**: Research indicates that the CEO succession plan is one of the top concerns for most corporations. While every Board recognizes the importance of succession planning, only certain companies have a well-documented succession plan in place. The Boards should recognize that succession planning is of paramount in the current economic situation. The Boards should have periodic discussions on succession planning. The nominations committee should understand the leadership talent and skills necessary on the Board, and look out for potential candidates who can be brought on to the Board.
- **Environmental Challenges**: In the coming years, corporations will face increasing pressure from its stakeholders to minimize the impact of its operations on the environment. The Board should be prepared to make more disclosures on aspects such as the company's carbon emissions, etc. The Board should recognize the value of using natural resources in a sustainable way.

Corporate Boards need to focus on enhancing the ethical judgment of employees, managers, executives and executive Board members, in the same way that they focus on developing technical and skill-based competencies. The Board should recognize and realize that people, not regulations, run companies and the measure of success in this area is the sum total of several day-to-day decisions taken by the management and employees at every level of the organization.

The Board should relentlessly strengthen the company's value system. Independent directors must be provided adequate orientation and access to the company's practices in this regard. Rigorous policies have to be implemented for evaluating the performance of independent directors, both in terms of self evaluation and peer evaluation.

Finally, Boards should ensure that the compliance is not just "to the letter of the law" but also to the "spirit of the law".